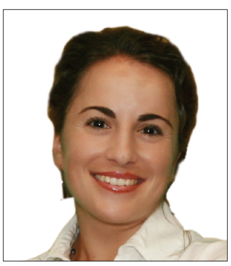
Premium Financing Risks



Renee Durepos
Vice President,
Operations,
Keal Technology.

Premium financing is a way for a brokerage to grow its business. But it's important to make sure the brokerage is protected against six potential risks.

Premium financing is certainly not a new concept. Banks, insurers and third-party finance companies continue to experience healthy profits by capitalizing on this lucrative revenue stream. As the insurance distribution landscape continues to evolve, the future of the independent broker hangs in the balance. Increased competition, easy access to information, legislative changes and rate increases are likely to send tech-savvy consumers comparison shopping come renewal time. Demonstrating the value of the independent broker is more complicated.

Selling insurance and serving clients is a labour of love for successful brokers. Creating an in-house premium finance company can make those laborious efforts at least 85% more profitable. It can also provide brokers with an additional tool to service accounts — specifically, hard-to-place personal lines and large commercial lines accounts.

Sound simple? Not so fast. When big players like AIG pull out of the premium financing arena, there is legitimate cause for additional caution. But it's hard to ignore the opportunity. If done correctly, the numerous benefits a broker can offer their clients and themselves outweighs the potential risks. The emphasis here is on the words "if done correctly."

In this spirit, we've summarized the Top 6 risks of in-house premium financing and ways to avert them:

Bad debts

Avoiding bad debt is critical. The process to avoid bad debt should not be so labour-intensive as to erode profits or introduce an element of human error. An automated system that flags and cancels clients in time to recoup unearned premiums is essential. Relying on an Excel spreadsheet doesn't cut it. Smart financing revolves around secure systems and procedures that virtually eliminate guesswork. The general rule is to accept a 25% down payment at the start of the contract. This padding greatly minimizes the risk of accruing bad debt, by providing enough capital to pay out the contract if early cancellation is required.

Interest rate management

An automated, secure system must be in place to calculate all interest charged, applicable late charges, and/or cancellation/other fees. This system must use the correct mathematical formulas that respect Canadian Laws. Example: the rule of 78's applies to the calculation of rebate of interest on a pre-paid account. Also providing clients with preferred or increased interest rate based on risk assumed needs to be easily managed for

Illustration by Paul Howalt/www.threeinabox.com accurate calculations. Using a system designed to manage the complexities of premium financing will do this simply and with integrity.

Client communication

Efficient client communication not only streamlines workflows but also assists in adhering to applicable laws. End-to-end audit trails encompassing the initial contract, the premium notice and the cancellation notice — and everything in between — must be stored should proof ever be required. All client communication must be worded to adhere

to Canadian rules and regulations. If not, the financing company could be held responsible.

An example of the importance of communication is as follows:

A client has defaulted on its payments. The finance company notified the insurance company, but the finance company didn't communicate the cancellation to the insured, and an accident ensues. The finance company may be held responsible for not clearly communicating the policy termination.

With a secure system in place, events are triggered automatically, flags are raised through reporting and activities are stored and locked for protection.

Securing credit with financial institutions

Without the appropriate resources, premiums simply cannot be financed. A system that automatically produces accounts receivables and dates them according to their age will simplify the procurement of the required credit. Not only does an automated system simplify the required reporting on a monthly or weekly basis, but it also meets initial requirements compulsory by a financial institution to secure the financing in the first place. Sophisticated management reports will also identify exactly where the revenue is coming from: regular payments, late fees, NSF charges, interest, etc.

Fraud prevention

Not protecting yourself from the possibility of internal theft is foolish. Processes and procedures must allow for ultimate transparency. An effective system will produce management reports, including month-end reports, to maintain necessary checks and balances to prevent employees from embezzling or kiting. A premium financing system provides secure, trustworthy reports used by management to verify all policies are legitimate. This prevents the manufacture of fictitious policies that creates the opportunity for an individual to embezzle the money that would be sent to an insurer to pay the balance.

Not doing it when your competitors are

Creating an in-house premium financing company to finance your brokerages clients can create a revenue stream to be reinvested in the brokerage. Many brokers are already dabbling in financing for specific, unique-needs clients or sending business to a third-party financer. Leveraging a premium finance system, integrated with the Broker Management System (BMS), can actually make the brokers sending policies for financing and the finance administrator processing contracts more efficient. This gain in productivity often eliminates the need to hire additional staff to manage the newly formed in-house premium finance company. The revenue generated goes directly to the brokerages growth initiatives instead of lining someone else's pockets.

Direct writers, banks and other brokerages offer financing and therefore can offer clients an additional, enhanced level of service. If clients are financed by the carrier with which they have been placed, the broker is limited by the insurer's rules; this may not be in the best interest of the client. Harnessing the power of one-stop shopping truly allows brokers to marry the needs of the insureds with the coverages available to serve them.

PREMIUM FINANCING AND GROWTH

We continue to see a flurry of mergers and acquisitions as successful brokers achieve their business objectives. Growth is one important factor to be competitive. Demonstrating a brokers' unique

value proposition is critical and offering a plethora of services, including in-house premium financing, is one way to do just that.

Premium financing isn't for everyone. Clearly venturing into this arena requires planning and a pragmatic approach to be protected and profitable. For brokers who understand and evaluate the above risks, and who implement secure systems to guard against them, the benefits are many and very lucrative.